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Financial Markets

Irving Trust

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Economic Research &
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(Noon)

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The recent reserve maintenance period (RMP) has been the most turbulent one since contemporaneous reserve accounting began; it was accompanied by great uncertainty concerning what the Fed intends for interest rates. Over the last RMP, the Fed operated on 7 of the 10 business days. In addition to four customer RPs, the Fed executed a four-day System RP to add reserves. On two occasions during the final days of the RMP, the Fed drained reserves with matched sales. Obviously there was some confusion as to reserve conditions in the market. Let's look closely at what the Fed was doing to better understand what it was attempting to do.

The clearest signal that emerges from the period's operations is that the Fed has been very rate sensitive. Visible open market operations have not been used in an offensive fashion but rather in a defensive fashion. The Fed did System RPs, adding reserves, with the funds rate at 10.5%--the effective rate for the day (March 22) registered 10.45%. On Tuesday and Wednesday (March 27 and 28), the Fed drained reserves, with matched sales, as the effective funds rate dipped to 9.62% and 8.81% respectively. Thus the timing of open market operations does not provide strong evidence that these operations were used to drive the Fed funds rate up--even though rates were high during the maintenance period, averaging above 10%.

In the Fed's own commentary after the period ended, it acknowledged that reserve forecast errors were made. These errors resulted in reserves being drained from the banking market beyond what was intended. This, in combination with the notion that open market operations did not drive rates up, provides an argument that the tightening we have seen, in terms of the high Fed funds rate, has occurred through events beyond the control of the Fed. It supports the argument that the Fed hasn't tried to tighten as much as it seems.

While this conclusion is supportable by the facts, this highly technical argument is off base. Concluding that the Fed did not act aggressively is not the same as concluding that the Fed has not tightened. Indeed, the Fed has tightened considerably. Market pressures intensified when the prime rate was raised. The Fed did not try and offset these pressures. On 7 of 10 business days, the effective rate for Fed funds was allowed to trade above the very important 10% level. Market pressures were so intense that the Fed did not have to be aggressive to get rates up. The System RP executed on March 22 to stem the rise in interest rates was so large that matched sales were executed later to drain the reserves back out. Granted there were problems during this period, with float draining reserves then adding them back. The Fed has given some detail on those problems, apparently in an attempt to clarify the odd operations. But, all in all, we get from this a picture of the Fed trying to keep Fed funds below 10 1/2% and above 9 5/8%. While factors other than Fed operations do affect rates, the Fed has been so careful with the funds rate that we must place emphasis on where Fed funds trade--and for how long. These factors are much more important than how the Fed gets them to trade there.

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Market Yields

	3/30/84 (Noon)	Week Ago	Year Ago
Prime Lending Rate at Irving Trust Company	11.50%	11.50%	10.50%
Effective since	3/19/84		
Discount Rate at Federal Reserve Bank	8.50	8.50	8.50
Federal Funds	10.38	10.31	8.88
Repurchase Agreements	10.13	10.00	8.75
U.S. Treasury Issues			
Bills			
3 months	10.05	10.10	8.67
6 months	10.47	10.55	8.67
1 year	10.77	10.87	8.61
Coupons			
2 years	11.55	11.55	9.63
4 years	12.08	11.97	10.25
7 years	12.45	12.35	10.50
10 years	12.49	12.43	10.88
Long Bond	12.51	12.50	10.38
Negotiable Certificates of Deposit-Secondary Market			
1 month	10.25	10.25	9.00
3 months	10.40	10.40	9.10
6 months	10.62	10.65	9.15
1 year	11.25	11.20	9.50
Banker's Acceptances			
1 month	10.33	10.28	9.00
3 months	10.54	10.45	9.05
6 months	10.89	10.75	9.20
Eurodollar Deposits			
1 month	10.50	10.68	8.75
2 months	10.62	10.75	8.75
3 months	10.81	10.81	9.00
Commercial Paper - Prime Names			
Directly placed by:			
Finance Companies			
1 week	10.16	10.21	9.14
1 month	10.22	10.38	9.19
3 months	10.40	10.40	9.20
Bank Holding Companies			
1 month	9.45	9.84	8.68
Dealer Placed:			
3 months	10.45	10.61	8.81
New AA Corporate Utility Bond	13.75	13.60	12.15
Tax Exempt			
6 month Project Notes	5.90	5.95	5.00
1 year AAA Bond	5.75	5.75	5.25
5 year AAA Bond	7.40	7.15	6.50
20 year AAA Bond	9.70	9.55	8.75

This information represents prevailing market yields.
It should not be construed as an offering.
All yields are on the offered side of the market.

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